

SHELL OIL CO.  
88 I.D. 1

IBLA 78-607

Decided January 5, 1981

Appeal from a decision of the Acting Director, Geological Survey, upholding the transportation allowance deducted to establish the reasonable value of production from various offshore oil leases for royalty purposes. GS-105-O&G.

Affirmed.

1. Oil and Gas Leases: Royalties--Outer Continental Shelf Lands Act:  
Oil and Gas Leases

The Secretary of the Interior has discretionary authority to determine the factors to be considered in computing transportation allowances for royalty valuation purposes. Where the Geological Survey applies a formula developed after appropriate research and consultation with affected oil companies and where the appellant does not provide convincing evidence that the 6 percent rate of return used in the formula is unreasonable as applied to appellant's production from 1968 to 1973, the transportation allowance will be upheld.

APPEARANCES: Vernon L. Terrell, Jr., Esq., Shell Oil Company, for appellant.

OPINION BY ADMINISTRATIVE JUDGE BURSKI

Shell Oil Company (Shell) has appealed the decision of the Acting Director, Geological Survey (GS), dated July 13, 1978, affirming an order of the Acting Oil and Gas Supervisor for the Gulf of Mexico area setting the transportation allowance to be deducted in determining the reasonable value of production from Shell's offshore oil leases for computing royalties for the period 1968-1973.

Inasmuch as no market price is available for offshore oil at the wellhead in the Gulf of Mexico, GS uses the market price at the first onshore market location less a transportation allowance to determine the value of production for the purpose of computing royalty. Shell built the Pompano and Cobia pipelines (GS Systems 51 and 51.1) to transport oil to shore from its various Outer Continental Shelf (OCS) leases in the Gulf of Mexico. <sup>1/</sup> When production began in 1968, GS and Shell agreed to a tentative transportation allowance of 15 cents a barrel with the understanding that the allowance would be readjusted based upon a more sophisticated computation at a later date.

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<sup>1/</sup> The Pompano pipeline services leases OCS-G 1294, 1610, 1614, 1901, 1966, and 1967. The Cobia pipeline services leases OCS-G 1666 and 1667.

On February 6, 1975, following submission of pertinent data by Shell, the Acting Oil and Gas Supervisor revised the transportation allowance applied to production transported through the Pompano and Cobia pipelines for the years 1968 through 1973. The revised allowance was \$1,312,325 less than the amount Shell had deducted based on the 15 cents-a-barrel rate, resulting in an increase in value for royalty computation by that amount.

Both in its appeal to the GS Director and its appeal to this Board following the Acting Director's decision, Shell has argued that the determination setting the transportation allowance was arbitrary and unreasonable. Shell urges that the formula used by GS is unreasonable and discriminatory because the 6 percent rate of return on investment allowed is unrealistically low and does not reflect a realistic return on its pipeline investment. Shell asserts a more realistic allowance would be based on the transportation charge of 10 cents per barrel that Shell negotiated with two other oil companies for use of its pipelines. 2/

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2/ When Shell first brought its appeal these oil companies apparently were paying royalties to the Federal Government based on a value for their oil determined by deducting a transportation allowance equal to the cost for transportation paid by the companies to Shell. Thus, Shell charged that it was being discriminated against since a different formula was being applied to it for its use of the same pipeline. Since then, however, GS has recomputed the allowances of the two other companies using the same formula as is disputed by Shell in this case. We shall not address the charge of discrimination further as it is moot.

In its statement of reasons, Shell also suggests to the Board three standards against which the Board should compare GS's transportation cost allowance for reasonableness. First, Shell notes again that the transportation cost allowance negotiated by Shell with third parties would be more reasonable than the GS formula. Second, Shell urges that the tariff that it would have to pay a common carrier operating the two pipelines by order of the Interstate Commerce Commission (ICC) would be more reasonable. Shell alleges that the ICC considers an after-tax 8 percent annual return on investment as fair and reasonable. Third, Shell urges that the GS allowance be measured against GS's own decisions allowing a 10 percent return on depreciated investment when prescribing royalties to be paid on liquids extracted in onshore gasoline plants operated by lessee operators.

In his decision the Acting Director indicated that the value of production was computed by using a formula that has been consistently applied by the Oil and Gas Supervisor for 10 years. The formula was described as an "objective rule" which "takes into consideration the pipeline operating costs, an allowance for depreciation, and a fair rate of return on the lessee's investment in the pipeline." The Acting Director indicated that the issue of the appropriate rate of return was researched, that affected oil companies were consulted, and that 6 percent was used based on a reasonable analysis of the issue at the time and would change as required by the economy of the pipeline

business. He also stated that GS was unable to confirm the alleged 8 percent ICC rate and nevertheless would not be bound by it if it existed.

[1] The Outer Continental Shelf Lands Act, as amended, 43 U.S.C. §§ 1331-1343 (1976), requires the payment of a royalty based on a specified percentage in amount or value of production from oil and gas leases on submerged lands of the OCS. Departmental regulation, 30 CFR 250.64, defines value of production as follows:

The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field or area, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price paid or offered at the time of production in a fair and open market for the major portion of like-quality products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

In addition, the leases signed by Shell state that the lessee, Shell,

expressly agreed that the Secretary may establish reasonable minimum values for purposes of computing royalty \* \* \* due

consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, or area, to the price received by the Lessee, to posted prices, and to other relevant matters.

One such relevant matter is the cost of transportation for royalty oil to an onshore market where there is no market at the offshore point of production. It has long been considered reasonable with respect to oil produced onshore or offshore to deduct a transportation allowance from the market value of the oil at the nearest open market to determine value at the wellhead where no market exists at the wellhead, the point where the oil would ordinarily be sold and valued. United States v. General Petroleum Corp., 73 F. Supp. 225, 262-63 (S.D. Cal. 1947), aff'd, Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); C & K Petroleum, Inc., 27 IBLA 15 (1976); Kerr-McGee Corp., 22 IBLA 124 (1975); Shell Oil Co., 70 I.D. 393 (1963). The Secretary of the Interior has discretionary authority to determine the factors to be used in computing such a transportation allowance for royalty purposes. Superior Oil Co., 12 IBLA 212 (1973); Shell Oil Co., supra.

There is no dispute in this case as to whether a transportation allowance will be permitted; rather, the dispute concerns the reasonableness of the allowance approved by GS in this instance. Shell contends that the amount allowed does not permit it a reasonable return on its investment. We have examined Shell's arguments and do not find

that they provide any basis for holding that GS's 6 percent rate is unreasonable as applied to the years 1968 through 1973.

First, we cannot accept Shell's assertion that the transportation cost negotiated by it with two other oil companies as part of the purchase price of their oil necessarily represents a fair rate of return on investment for royalty valuation purposes. Shell has not indicated what rate of return it actually receives from the transportation cost element of the contracts and, while the rate of return reflected may well be fair with respect to its dealings with the two companies, it may represent more than a minimal fair rate of return generally.

We note that the oil companies had to choose between selling their oil to Shell in the field or selling the oil onshore after obtaining some alternative mode of transporting it to the onshore market. This could have entailed barging the oil or possibly construction of additional pipelines. So long as the price charged by Shell was competitive with these alternative transportation options it would be in these oil companies' economic self-interest to pay the Shell price. The ceiling price would not relate to Shell's rate of return. Rather, it would be dependent upon the cost of the alternate methods of transportation. If the alternative transportation costs were significantly more expensive, Shell could calculate a transportation charge with a high rate of return on its investment yet with a

cheaper and therefore agreeable result for the other oil companies. Such rate may well result from a fair arm's-length transaction in the market place but not necessarily represent a fair rate of return with respect to the valuation of Shell's own oil for royalty purposes.

Second, Shell urges that the rate of return allowed in computing the transportation allowance be comparable to that allowed in establishing common carrier rates for pipelines. Shell claims that the ICC "has long since determined that an eight percent annual return on investment in such cases is fair and reasonable" and cites an ICC decision entitled, Reduced Pipe Line Rates and Gathering Charges, 243 I.C.C. 115 (1940) (hereinafter Reduced Rates). Shell also notes that, unlike the GS determination, a fair rate for ICC purposes is an after-tax rate since the ICC has held that Federal corporate income taxes are a part of the cost of operation insofar as calculating a fair rate of return. Minnelusa Oil Corp. v. Continental Pipe Line Co., 258 I.C.C. 41 (1944).

We have examined the above-noted cases and disagree with Shell as to their applicability to the case before us. It is true that in the Reduced Rates case ICC set 8 percent as a fair rate of return on investment for the various pipeline carriers examined in that case and that the 8 percent rate was reapplied in the second case. It is also quite evident, however, that the choice of 8 percent was arrived at after examining all of the circumstances relevant to the pipeline



carrier business at the time and that the ICC rates were determined on a case-by-case basis. We find that the determination of the fair rate of return for common carriers in 1940 has little direct applicability to the case at issue.

This view is sustained by the findings of the United States Court of Appeals for the District of Columbia in Farmers Union Central Exchange v. Federal Energy Regulatory Comm., 584 F.2d 408 (1978). In this case the court concluded that there was a lack of viable precedents in the area of pipeline rate making and a lack of an established rate-making theory on which to base a present determination of reasonable rates for pipeline common carriers. With respect to past ICC pipeline rate cases, including the two cited by Shell to support its argument, the court stated:

Second, based on rather detailed analyses of economic conditions facing the industry in the 1940's, the Commission's 1940's decisions determined that oil pipeline rates should allow carriers to recover operating expenses plus no more than either an 8 percent return on value for transmission of crude oil or crude oil plus refined petroleum products \* \* \* or a 10 percent return on value for transmission of gasoline. \* \* \* The ICC pointed out that by 1940's standards these rates of returns were "somewhat larger . . . than . . . would be reasonable to expect would be applied in industries of a more stable character, where the volume of traffic is more accurately predictable." \* \* \*

In the Commission's estimation, these "somewhat larger" rates of return were justified on the one hand by the need to attract capital to the oil pipeline industry despite the higher-than-normal risks faced by carriers of petroleum products, and especially of gasoline, and on the other hand, by the need to keep rates low enough to forestall the dangers of oligopolistic control of the oil pipeline industry by the big producers. Other factors considered by the ICC were the possibility of price fixing and a history of "enormous" profits, the cost-effects of greatly increased taxation during the 1930's, the increased demand for oil products, the improved technology of pipeline transmission precipitated by World War II, and the prediction that economic forces would cause rates to drop regardless of ICC action. Notably, aside from brief discussions of increased labor costs, the ICC's decisions make clear that operating costs other than taxes were relatively free from inflationary (or deflationary) influences from 1937 to 1947.

To the extent that economic conditions facing the oil pipeline industry have changed since 1948 -- and, in light of the modern onslaught of inflation, petroleum shortages, and reliance on imports, as well as the maturing of the industry itself, we may readily assume they have--the conclusions of the ICC in its earlier cases as to appropriate rates return are equally as much artifacts of a bygone era as is its reliance then on a valuation rate base.

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We find the ICC's discussion of rate of return equally problematical. Here the total emphasis is on the 1940's precedents: because 8-10 percent was a viable return for carriers of petroleum products from 1940 to 1948, it is said, so must it be today. Even more so than the choice of a reasonable rate base methodology, a "reasonable rate of return" determination must be the product of the economic moment. As noted earlier, the ICC's choice in the 1940's of the 8 and 10 percent figures turned on such "hazards" as the infancy of the gasoline industry, the likelihood of disruptive discoveries of new oil fields and the unidimensional nature of the product market served by pipeline carriers, as well as on such factors as unduly high profits in the past, high taxes, and a rapidly expanding economy relatively free of inflation. \* \* \* Absent some accompanying assessment of how this complex of relevant

factors has changed in thirty years, the ICC's reliance on its antiquated precedents in determining a reasonable rate of return differs little from a rule that would require modern automobile accident damages to conform to those awarded by juries in 1940. [Emphasis added.]

584 F.2d at 415-16, 419-20 (citations and footnotes omitted). In addition, we note that the ICC reopened the Reduced Rates case in 1948 and upheld only a 7.6 percent rate of return rather than the original 8 percent rate. 272 I.C.C. 375 (1948).

Shell's third argument is based on a comparison of the 10 percent return on depreciated investment allowed in the calculation of royalty to be paid on natural gas liquids extracted at onshore gasoline plants. This rate is set forth in notices issued by GS on June 1, 1978, with an effective date of July 1, 1978. Shell urges that since a 10 percent rate is allowed onshore, a higher rate should be allowed for an offshore investment "where the risk should be higher." We do not agree that these notices represent a reasonable basis for determining the fair rate of return on Shell's investment. There is more to such a comparison than the single issue of greater risk. Other factors must necessarily be considered in making such a comparison. The most obvious is that we are examining a rate for the period 1968-1973, whereas the GS notices apply to circumstances after July 1, 1978. Obviously, the fairness of any rate of return varies directly with subsisting general inflation rates. The economic situation which obtained in the period examined herein was vastly different from that which was extant in 1978.

It is evident from our investigation that a fair rate of return depends greatly on the economic conditions and other circumstances of the case at the time involved. GS apparently developed the transportation allowance formula after appropriate research and with input from affected oil companies. Shell has challenged the GS transportation allowance as unreasonable. However, Shell has not disputed the methodology used by GS, nor provided any specific factual basis which would support a finding that the 6 percent rate was unreasonable or that a different rate would be more reasonable for the period from 1968 to 1973. Therefore, we must affirm the GS determination. 3/

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision of the Acting Director, Geological Survey, is affirmed.

James L. Burski Administrative Judge

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We concur:

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Bernard V. Parrette  
Chief Administrative Judge

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Douglas E. Henriques  
Administrative Judge

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3/ We do not wish to intimate that the rate of return, which we sustain for the period from 1968 to 1973, is an inflexible standard to be applied in all time frames without reference to exogeneous economic factors. On the contrary, we reject such a viewpoint. Our holding herein is expressly limited to the period from 1968 to 1973.

